Beckner & Associates, Inc.
Commercial Real Estate Services

How Do You Make Money In Commercial Real Estate Investment?
What Should I buy?

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Knowledgeable real estate investors know there are three primary ways to make money in commercial real estate. They are cash flow, appreciation and principal buildup through paying down a loan. An investment can offer only one of these or all three. Which investment is right depends on the investor's personal needs which may change over time and his resulting emphasis on these three factors. But to understand how these three work there are other concepts that must be discussed.

The first term that an investor needs to understand is "net operating income". This is the income that remains once all the operating expenses have been paid but before mortgage payments are made.

The second is "capitalization rate." This is a measure of risk that fluctuates with various factors such as interest rate, location, leases, etc. The riskier the investment the higher the capitalization rate should be. A property leased to the government or a fortune 500 company will have a significantly lower capitalization rate than a property in a poor location and leased to a recently formed company. This term can also be interpreted as the return an investor would receive if he paid cash for a property. Thus an 8% capitalization rate would result if an investor received $80,000 net operating income on a $1,000,000 investment. In reverse an investor should be willing to pay $1,000,000 on a property with an $80,000 net operating income.

Most people understand cash flow. It is the money left from rental income after the investor pays his mortgage and expenses. Investors often refer to the term "cash-on-cash return." This is the cash flow divided by the down payment the investor needed to make. So a property that cost $1,000,000 would have a 12% cash-on-cash return if the investor put down $200,000 and had cash flow of $24,000. But, many investors do not realize that the cash-on-cash return is different than the capitalization rate and greatly impacted by the loan terms they are able to negotiate.

If an investor purchased a building for $1,000,000, paid cash for the property and received $100,000 in cash flow he would have a 10% capitalization rate and a 10% cash-on-cash return. On the other hand, if the investor leveraged his money by putting only $200,000 down and borrowing the other $800,000 he would make a better cash-on-cash return. For example, if he is able to borrow the money at 7% interest and a 20 year amortization, his annual mortgage payments will be $73,997. Thus his cash flow is $26,003 and his cash-on-cash return is 13%. He has invested less money but gotten a higher rate of return. In addition, at the end of the 20 years he will have no debt. He has paid off the $800,000 through the income he received. This shows that leverage through debt can greatly increase the return he receives. If he wishes to fully leverage the initial $1,000,000 he could purchase $5,000,000 in real estate instead of only $1,000,000. His cash flow would be $130,015 per year, or an additional $30,015 per year. In addition, he would have paid off the entire $5,000,000 at the end of the loan. This shows the power of leverage. But, leverage increases an investor's risk. If the income stops the cash buyer simply has no income, but he does not have to fund the mortgage out of other funds. The more leverage used the greater the potential risk to cash flow.

The above shows the power of leverage to increase cash flow. It also shows that leverage can greatly increase the equity that can be built by letting the lessee pay down a mortgage. In the cash example there was significantly less risk, but at the end of 20 years he still has a property worth $1,000,000 ignoring appreciation. In the highly leveraged example the investor has property worth $5,000,000 fully paid off. The investor must weigh the risk of the additional debt versus the increased equity.

The third primary way to generate wealth from real estate is through appreciation. Most commercial real estate will appreciate over time provided the property is maintained and the surrounding area does not decline. In proformas most people assume an annual appreciation rate of 2-3%. Thus in the above examples, a $1,000,000 building would become worth $1,806,000 over 20 years at 3% annual appreciation. The $5,000,000 building would become worth $9,030,000. Thus leverage again is a major factor in wealth accumulation. At the end of 20 years in the difference in the total return is very significant. Most investors therefore leverage their properties.

Two other factors come into play. The first is depreciation. The larger investment will have greater depreciation. This can result in greater tax savings depending on the investor's overall tax situation. The second factor refers to the impact of leverage over time. As the investor builds equity over time from appreciation and paying the loan down, he is in fact not receiving the same cash-on-cash return based on his then current equity position. He can greatly increase his cash-on-cash if he refinances the property and takes the excess equity and purchase another building. This results in greater cash flow, and a larger base on which to receive appreciation and loan reduction. The secret to building a significant real estate portfolio is utilizing the vast power of leverage.

But, we return to the concept of risk. If an investor wants to maximize his return he will continue to be leveraged and increase his holdings as rapidly as possible. On the other hand many people do not want that level of risk. In determining what investment to pursue one can not only say "I want a good deal." What is a good deal for one investor may not be attractive to another. The issue is similar to the decision of what stock to purchase. Do you want liquidity? Dividends? Growth? How much risk can you tolerate? The obvious answer is yes to all of these. Similarly, the real estate investor would be ecstatic if he could get great cash flow, high appreciation, and have a fortune 500 company paying off his favorable loan. If an investor waits for all these factors he will probably never find it. The issue is which is the most important. If cash flow is important then investing in land is inappropriate. On the other hand, land investment offers significant appreciation.

As a result investment alternatives can best be viewed as a continuum based on risk. At the least risky is the government leased property or the property leased long term to a major company. These properties are sold at low cap rates. This makes the use of leverage difficult since the cap rate and available interest rates are too close. These properties are usually purchased with cash and might be considered similar to a bond. Thus there is no equity build-up from a loan. Also, appreciation is usually low due to little increase in the income stream over a long term.

At the other end of the continuum is speculative construction and “value added” properties. Speculative construction starts with little or no income stream. The decision to build is based on the investor’s believe that the market demand is sufficient to lease or sell the property over a reasonable length of time. Obviously, if he is wrong the interest carry reduces his profits and may in fact result in a loss. Value added properties are properties that are purchased in a distressed condition either due to the physical and/or financial condition of the property. The investor purchases the property with the intent to solve the problems and as a result have a property that is worth more than the initial purchase price plus the cost of solving the problems. This is similar to remodeling homes with the intent to lease or sell once the remodeling is finished. Often the problem is vacancy and the resulting low income stream. The buyer purchases the property, makes any needed repairs, and invests the necessary time and resources to lease the property. As a result the investor has appreciation. He can continue to own the property with the higher cash flow he can sell the property or as discussed above he can refinance the property and purchase another. By his efforts he has obtained cash flow and appreciation.

What willingness of the investor to take risk and his desire for cash flow, appreciation and/or loan reduction will determine which property is best for him. Younger investors with other income streams often wish to build a real estate portfolio and will take a riskier approach. As investors mature they may take a more conservative approach and feel a greater need for cash flow. Once an investor determines the best route for himself he can evaluate an investment wisely and best meet his economic goals.